CBA | CONSUMER BANKERS ASSOCIATION

March 28, 2005

Jennifer J. Johnson, Secretary
Board of Governors of the Federal
Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

Re: **Docket No. R-1217; Advance Notice of Proposed Rulemaking**

Dear Ms. Johnson:

The Consumer Bankers Association (CBA)[1] is pleased to submit these comments on the Advance Notice of Proposed Rulemaking (ANPR) concerning the open-end credit provisions of Regulation Z implementing the Truth in Lending Act (TILA).

## I. Introduction

While in the comments that follow will address many of the questions posed by the Board, we want to state very clearly our overall view toward this ANPR exercise. We would not want to invest our time and energy, and that of countless other interested parties, in an exercise that is merely cosmetic or superficial, or that entails substantial new costs and risks for the credit industry without demonstrably commensurate benefits for consumers and the credit markets, or that cannot realistically be completed and integrated with the rest of TILA and Regulation Z within a reasonable time. The possibility of these unfortunate outcomes is avoidable, we believe, if the Board sets an appropriate agenda and scope for the project, pursues real issues of substance, and insists that the project proceed expeditiously.

### a. Review of Regulation Z is overdue.

It is also useful to recognize the unique opportunity this ANPR presents. The basic open-end credit disclosure provisions of TILA and Regulation Z have been on the books since 1968 – thirty seven years ago. The significant credit card provisions added by the Fair Credit Billing

1 The Consumer Bankers Association is the recognized voice on retail banking issues in the nation's capital. Member institutions are the leaders in consumer financial services, including auto finance, home equity lending, card products, education loans, small business services, community development, investments, deposits and delivery. CBA was founded in 1919 and provides leadership, education, research and federal representation on retail banking issues such as privacy, fair lending, and consumer protection legislation/regulation. CBA members include most of the nation's largest bank holding companies as well as regional and super community banks that collectively hold two-thirds of the industry's total assets.

Act are more than 30 years old, and even the more recent additions of the Fair Credit and Charge Card Disclosure Act, and the Home Equity Consumer Protection Act date back to 1988, 17 years ago. The statutory base, and the bulk of the implementing rules in Regulation Z, are very dated. While the Act and Regulation were significantly overhauled by the Truth in Lending Simplification and Reform Act of 1980, very little of that revision dealt with open-end credit, and what modest changes were made on the open-end side are themselves a quarter of a century old. Historically, closed-end was the traditional form of consumer credit, where the practices and issues were familiar, and needed changes could be identified and enacted relatively easily. If "simplification and reform" were justified on the closed-end side barely a decade after TILA was enacted, the time for a serious and thorough look at the law and its regulatory implementation is long overdue. The project that is needed is a concentrated look at all of Regulation Z, in light of technological change, product and marketing developments, the evolution of delivery systems, and economic and behavioral data on consumer perceptions and use of credit cost information.

**b. Need for baseline data.**

It states the obvious to note that the consumer credit marketplace has changed over thirty five years. One of most significant changes has been the growth of open-end credit, led by credit cards and home equity lines, to the point where open-end credit is more prevalent than closed-end for most consumer uses, perhaps excepting home mortgages. Open-end credit is itself developing in new modes. HELOCs are one fairly recent pattern, virtually unknown in 1968. Cardless open-end plans, and open-end lines wrapped around purchase money mortgages, are being introduced. Open-end credit through bank cards accepted worldwide has virtually replaced the closed-end arrangements once offered by individual merchants. Open-end lines expire and balances are converted to a fixed-term (closed-end) payment period. Indeed it is difficult to say anymore exactly what is the essential differentiating factor between closed-end and open-end credit, where fluctuating rates, balances, and repayment patterns may be found in both forms. Even the reusable or "replenishing" characteristic of open-end credit can be replicated on the closed-end side by a series of refinancings triggered by call provisions or customer choice.

In 1968 Congress settled on the closed-end/open-end distinction because it was already in use in the marketplace, and seemed to provide a way to deal adequately with the uncertain payment schedules introduced by revolving credit cards. It was an artificial concession that hopefully would make closed- and open-end credit pricing comparable. Since then, Regulation Z builds quite different disclosure systems for each form of credit, and this ANPR suggests possibilities that would make them even more dissimilar. We submit that the Board and other interested parties *should be looking for ways to bring both patterns closer together*, rather than pushing them farther apart. It would be a mistake, therefore, to go through the motions of a Regulation Z rulemaking without first developing the clearest possible picture of the conditions and trends in the consumer credit markets as a whole. With such a picture, it might then be possible to identify and consider options for reform in a systemic way that could revisit whether the historical bright line between open- and closed-end approaches to credit disclosure should be maintained, or whether new combinations, or hybrids, of disclosure structures might be devised. Some CBA members have suggested "town hall"- type meetings to develop data and information concerning market developments. Other forums or information-gathering processes may work as well or better. We suggest only that this step be undertaken early in the process.

**c. Cost-benefit implications.**

There is a certain inherent ambivalence about regulatory overhaul on the part of the regulated industry, and that is certainly true on the part of CBA members considering the prospect of significant revisions of Regulation Z. Revisions of the disclosure protocols of Regulation Z inevitably involve significant transition costs for forms redrafting, legal due diligence, systems modifications, employee training, and the like. Especially with respect to disclosure requirements where statutory damages and class actions are implicated for less-than-perfect compliance, it can be a daunting, and expensive, challenge to incorporate new or modified disclosures in the finite spaces on transaction documentation. There is also the fear of disclosure overkill, or "information overload," that may make the aggregate of the disclosures counter-productive, or at least redundant of information furnished as a matter of contract. To make this kind of transition expense worthwhile, CBA members – and the rest of the consumer credit industry, we believe – would have to believe that the long-term gains outweigh those front-end costs. This makes it difficult for us to take specific pro or con positions on each of the numerous suggestions in this ANPR. We would need to see an integrated rulemaking proposal to assess the net short-term costs as against the net long-term gains.

While some commenters may bring to this Regulation Z ANPR an attitude that "it ain't broke," so don't spend time trying to fix it, CBA does not. Although we cannot now say exactly what changes might be feasible and worthwhile, we are prepared to work with the Board and other interested parties to sort out those issues. We would be delighted eventually to support a package of commentary, regulatory, and possibly statutory changes that promised to bring greater transparency to consumer credit transactions without inordinate industry compliance costs and litigation risks. Conceivably, the Board might deal with some of these matters by bringing to bear its "unfair or deceptive acts or practices" powers, either by selective enforcement actions against creditors that engage in deceptive practices, or by promulgation of regulatory guidance, or best practices, under the aegis of Regulation AA.

## II. Scope of the ANPR [ANPR Q1]

As intimated above, we believe the scope of the proposed rulemaking is much too narrow. We appreciate that it may be unwieldy to take on the entire Regulation Z at once, and that some staging may be necessary. But focusing on non-realty secured open-end plans is too skimpy for what will be the first serious review of Truth in Lending in many years. Most of the relevant provisions in Subpart B of the regulation apply equally to HELOCs and to credit cards. Some HELOCs are accessed by credit card, and it makes little sense to evaluate one portion of such plans in isolation from the rest. There are also many "crossover" issues implicated in Subpart B that affect closed-end transactions as well, including matters of format, timing, definitions, rescission, identification of finance charges, and APR calculations. Moreover, concentrating only on a subset of open-end credit reinforces the assumption that the current division between open-end and closed-end regulatory regimes is immutable. At a practical level, as well, reviewing Regulation Z in too many stages risks prolonging the whole exercise unduly.

Some CBA members support a comprehensive review of Regulation Z in its entirety. While others concede the need for at least several steps, virtually all agree that the proposed scope of this ANPR is too limited. CBA believes that the Board should expand the scope of this initial review to comprise at least the following:

Subpart A (general provisions), especially Sections 226.2 (Definitions) and Section 226.4 (Finance Charge).

Subpart B (open-end credit).[2]

Subpart F (electronic communication).

The review exercise should obviously keep in mind the overall linkage of open-end and closed-end disclosures so that core concepts remain consistent.

**III. Formatting Requirements** [ANPR Questions 2 through 12].

We begin by noting the sharp contrast in the disclosure format rules for closed-end and open-end credit. Both sets of rules derive from the general "clear and conspicuous" standard, and the earlier "meaningful sequence" requirement. In the 1980 "simplification" process, the format rules for closed-end credit were significantly revised, to require segregation of the disclosures into what is now called the federal box. But no comparable segregation requirement was instituted for open-end credit; indeed the format rules for open-end plans are bare bones, and permit creditors to intermix required disclosures with contract provisions and other informational items so long as the disclosures remain conspicuous. This difference in approach is partially attributable to the case law confusion about closed-end formatting in the early years of TILA, and the attempt to resolve it in the 1980 statutory revisions. It is also attributable to the difference in the nature of the disclosures between closed- and open-end credit. The snap-shot approach for closed-end credit emphasizes specific numbers that represent fixed transactional cost elements. Contingent fees, such as for default, are merely referenced to the parties' contract. And future adjustments and modifications are largely ignored as "subsequent events."

For open-end credit, the solicitation and account opening disclosures, except for the Schumer box, are largely narrative descriptions of how balances and charges are calculated, and how other account features operate. It often makes sense, and enhances understanding, if the creditor presents the required disclosures as part of a sequenced series of contract information, which obviously may vary from creditor to creditor and product to product. It is very difficult, we believe, to require standardized formatting for these early disclosures in open-end plans. There is no "one size fits all" template for the solicitation and account-opening disclosures, and if one were forced into Regulation Z it would almost certainly fail its informational function and stifle the industry's ingenuity in product design and informational presentation. An "executive

[2] The provisions derived from the Fair Credit Billing Act, principally § 226.10 through § 226.13, and § 226.15 on rescission, might be deferred to a later stage, thus keeping the present exercise centered on disclosure matters.

summary" approach would apparently build on the existing Schumer box rules, but would add a page to the disclosures (at substantial costs market-wide), and would risk distracting consumers from the more complete information in the contract.

As to periodic statements, where more of the required disclosures are numerical, it may be possible to develop a more standardized format for them, which CBA could support if it did not involve unduly expensive systems and forms-design modifications. In part this would depend on whether significant new disclosures are imposed, of the types suggested by the Board elsewhere in this ANPR. And it would depend absolutely on the existence of empirical and behavioral validation of new format specifications.

In any case, we believe that efforts to standardize disclosure format should be done less by regulatory dictate (as in closed-end credit), but rather by developing sample or model forms that provide a safe harbor for creditors who use them and a best practices benchmark for those who wish to customize. Any such sample or model forms should be extensively tested for its behavioral effect on consumers.

## IV. Classifying Open-end Charges [ANPR Q13 through Q20]

The ANPR correctly notes the growth in fee income for creditors as they unbundle their pricing components. Uncertainties then abound concerning the proper treatment of customer fees as "finance charges," or (in open-end plans) "other charges," or something else altogether. These issues have peaked over the past decade in several Board rulemakings concerning debt cancellation agreements (DCAs) and charges for expedited payment or delivery of a credit card. The Board staff has indicated in the Federal Register that certain new forms of DCAs are presumptively finance charges,[3] but has not proposed a formal rulemaking on the point. While these issues arise in the context of open-end credit, they involve interpretation of the generic definition of "finance charge" that applies equally in closed-end credit. This therefore presents one of those cross-over issues that runs throughout Regulation Z, and cannot be confined to open-end plans.

CBA believes it is time for a return to basics with respect to the characterization of the variety of such fees creditors are imposing. That should include rethinking the basic concept that "finance charges" are "imposed . . . incident to" an extension of credit.[4] In general, it would seem that this definition should be restricted to fees and charges for products, services, or account features that materially affect the traditional economic components of the cost of the credit. Fees and charges for ancillary and optional products, services, or features would be excluded from that definition. The ANPR notes various finance charge formulations suggested by the industry,[5] but indicates no preference among them. CBA would want to consider carefully the practical effect of each of these approaches before supporting any one of them.

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[3] 68 Fed. Reg. at 68.795-96 (2003).

[4] Regulation Z § 226.4(a).

[5] See also: R. Rohner & T. Durkin, *TILA "Finance" and "Other" Charges in Open-End Credit: The Cost-of-Credit Principle Applied to Charges for Optional Products or Services*, 17 LOYOLA CONSUMER L. REV. 137 (2005).

The open-end credit rules recognize an additional category of "other charges," and still a third category of charges that are neither finance charges nor "other charges." There seems to be no principled basis for these latter two characterizations, especially the statute-based "other charges" category.[6] It might therefore be possible to streamline the "other charges" category to limit it to charges relating to default, delinquency, or termination of the account. It would also be possible, we believe, to substitute for the existing category of "other charges" a blanket notice that the customer should look to the contract for further information about default and delinquency charges. This would parallel the treatment of those kinds of charges in closed-end credit under Regulation Z § 226.18(p).

## V. Over-Credit-Limit, and "Penalty," Fees Generally [ANPR Q21-Q22]

The Supreme Court in *Pfennig* clearly recognized both the difficulty and the need for regulatory line drawing in connection with a sweeping definition such as that of "finance charge." We urge the Board to take its cue from the Court, and leave the rule on over-limit fees alone. To try to differentiate whether such a fee is a legitimate delinquency charge, or whether it crosses some vague definitional line and becomes a finance charge, would introduce unneeded complexity and uncertainty on the matter. If this disclosure remains an "other charge," it is fully disclosed in the account-opening disclosures, and on the periodic statement when it is imposed.

In our view, the same conclusion applies to various forms of "penalty" fees or rate increases triggered by the consumer's conduct regarding the plan. The creditor's right to impose the fee or increase the rate must rest in the contract of the parties. To add a new mandatory, and presumably detailed, TILA disclosure about each such fee or rate increase is to that extent duplicative and unnecessary. If the contract is ambiguous, unclear, or deceptive regarding such penalty charges, a court may refuse to enforce it. Indeed, we would make the same point with respect to many of the possible new disclosures suggested in the ANPR. If they are validly in the parties' contract, there is no need to repeat them in a separate TILA disclosure beyond, perhaps, a reference in the disclosures to the relevant contract provisions. If open-end plans are being marketed or maintained on the basis of unfair or deceptive practices by creditors, the appropriate supervisory agency ought to police them accordingly.

As to the practice by some creditors of reserving the right to impose fees, reduce caps, or increase rates, based on a consumer's delinquency to another creditor, we reserve judgment. To the extent such adjustments are based on sound assessments of economic risk, we believe they are justifiable. But we also believe that the market may be somewhat self-policing on this matter, based on customer relations concerns and competitive pressures. Again, these provisions are part of the parties' contract, and to the extent there are questions of fairness or deception in the contracting process, they can be dealt with on that basis without layering on a detailed additional disclosure.

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[6] TILA § 127(a)(5), Regulation Z § 226.6(b), with respect to account-opening disclosures. There is no express statutory source for a disclosure of "other charges" on periodic statements, but this is required under Regulation Z § 226.7(h).

## VI. Historical APRs. [ANPR Q23–Q25]

CBA believes that the currently required computation and disclosure of an "historical" APR is anomalous, economically unsound, and of little value to consumers. It is an anomaly at least in the sense that there is no comparable retrospective APR disclosure in closed-end credit, even though payment patterns and other events can change the effective APR in a closed-end account just as in open-end. As applied, for example, to transaction charges like cash advance or balance transfer fees, the historical APR is economically unsound because it assumes that the consumer repays the advance or balance, and the fee, in a single period, when in fact the consumer often will revolve those balances and fees over a number of periods. In fact, a curiosity of the Appendix F formula is that a consumer can *decrease* the effective historical APR by drawing *more* credit, thus increasing the balance to which the transaction charge is related. It offers little useful information to consumers beyond a distorted and artificial look back at a short-term APR. We are aware of no behavioral research on whether and how consumers react to historical APRs. Consumer representatives tout the "shock value" of sharp spikes in the historical APR based on non-rate finance charges, but they do so without empirical support and without acknowledging its distortions.

The historical APR could be abolished, we believe, without any measurable loss in disclosure content. We realize, however, that there is a policy argument for retaining some version of it as a hedge against creditors shifting their pricing from periodic rates to transaction-triggered fees and charges. If the historical APR were dropped, only the annualized periodic rate would remain as the disclosed APR, and the impact on the APR of other finance charge elements would disappear. The Board suggests some possible alternatives to the present historical APR, such as a periodic or annual compilation of the dollar totals of finance charges. We believe this has promise as a more useful, realistic piece of information than the historical APR.

## VII. Balance Assessment Methods [ANPR Q28–Q30]

Balance assessment methods (BAMs) have been a little-understood aspect of open-end credit pricing since the 1960s. While virtually all creditors now use some version of an average daily balance formula, there are numerous variations on how the formulas are structured and calculated. The disclosures of BAMs under Regulation Z §§ 226.6(a)(3) and 226.7(e) are often complex, and dense, reflecting the intricacy of the arithmetic they describe. In theory it would be convenient if Regulation Z could standardize BAMs in open-end credit in roughly the same way it standardizes the calculation of the Amount Financed in closed-end; but this is just not feasible. Probably very few consumers use the BAM disclosure for its intended purpose, *i.e.*, to verify the creditor's calculation of the balance and the resulting periodic rate charge. Yet creditors ought to retain the freedom of contract to establish whatever formula they choose, so long as it is not imposed unfairly or disclosed deceptively.

Some old empirical studies – and common sense – confirm that the BAM used can affect the amount of finance charge an individual consumer pays, since it depends on when charges are incurred and paid, and whether balances revolve. But across a portfolio of open-end accounts, and over time for individual consumers, we believe there is a certain leveling effect, so that the difference in creditor yield does not vary greatly from one BAM to another. Before piling on new disclosures, the Board ought to insist on empirical data on the impact BAMs have on consumer costs.

In the interest of simplifying disclosures where possible, this might be an instance where the required TILA disclosure should be merely a reference to where in the contract the balance formula is spelled out.

**VIII. Effect of Making Minimum Payments** [ANPR Q31–Q33]

At this writing it appears that disclosures along this line will be enacted as part of the pending bankruptcy bill, so the Board will not have the luxury of reviewing them in the context of this ANPR. Notwithstanding our support for the bill, we have long believed that such disclosures are unhelpful to consumers. Patterns of consumer payments on open-end accounts are unpredictable, and any amortization disclosure based on minimum payments is wholly speculative and unrealistic. Indeed it will likely change with every periodic payment, except for that occasional customer who makes no new purchases and only minimum payments every month. Data on minimum payment patterns may be available from the Credit Research Center (Georgetown University) or other sources.

The emergence of products such as a purchase money mortgage combined with an equity line may force the Board to fashion a way to deal with products that are partly closed-end and partly open-end.[7] We are not averse to considering an amortization schedule in such products under some circumstances, as that might be a way to bring closed- and open-end accounts closer together and to create a useful kind of hybrid disclosure structure.

**IX. Allocating Payments.** [ANPR Q34–Q36]

Informal feedback from CBA members indicates they may use a variety of contract provisions on the allocation of consumer payments. Typical provisions apply payments to penalties and delinquencies first, then to balances outstanding. Absent any state or federal law ordering the application of payments in a particular order, CBA strongly believes this should be left to the contract of the parties, and not subjected to a new disclosure rule. This is another example of a potential litany of credit contract provisions where some consumer at some time may have a particular interest in some aspect of the contract relationship with the creditor. This does not mean that every aspect of that relationship should be the subject of explicit, “conspicuous,” and duplicative mandatory disclosure. This would be pure disclosure overkill. Absent any evidence of misinformation or deceptiveness in prevailing practices, making a new disclosure of payment allocations is unjustified. We would note also that there has never been any comparable disclosure of payment allocations in closed-end credit.

[7] There may already be a model for such arrangements. Some credit unions and thrifts have for years offered open-end plans that include sub-plans for various kinds of loans, from credit cards to conventionally closed-end auto and home improvement loans, which the Board has implicitly approved as open-end credit. Commentary ¶ 2(a)(20).3-i.

**X. Substantive Rules for Open-End Plans** [ANPR Q43–Q51]

The special substantive rules for credit cards and other open-end accounts, chiefly from the Fair Credit Billing Act, are thirty years old. Industry practices have been shaped by them, rather than *vice versa*. But after that span of time, it might be worthwhile to assess how efficiently the current rules work in contemporary markets. We have no pre-conceived notions on these matters, but can think of several questions to examine:

– How well do the error resolution procedures work? Should the time limits be extended, or reduced? Does the definition of "billing error" need refinement? Should the rule that billing errors must be asserted in writing be relaxed to accommodate phone or Internet communications?

– Do the rules on unsolicited issuance need adjustment to take into account new forms of access devices?

– Should the $50.00 deductible for unauthorized use liability be adjusted to a current dollar equivalent?

As to convenience checks, we are not aware that customers have had, or alleged, problems relating to the underlying credit account. Since the payee of the convenience check is not necessarily a participating merchant in the card-issuer's network, it is virtually impossible for the card-issuer to handle billing errors, crediting of payments, anti-holder-in-due-course or unauthorized use claims, and similar matters that would require the cooperation of that payee. Consumers are, we believe, adequately protected by the laws applicable to checks as such.

We have not had a chance to canvass our members concerning their use of cut-off times for posting payments, but our sense is that these are established for operational reasons, and not to abuse consumers. In any case, if this is a problematic issue for open-end creditors, it must be equally so for creditors extending closed-end credit.

**XI. Other matters.**

Our final comment concerns ANPR Q56, on the possible need for legislative changes. Whether any such changes are appropriate or desirable is a question that ought to *follow*, not precede this ANPR exercise. It may appear, as the Board evaluates the ANPR responses, that certain statutory changes could facilitate and authorize disclosure adjustments that now seem locked in, or prohibited, by statutory language. One possibility might be statutory authority for the Board to develop a new disclosure approach that combines features from the presently mutually exclusive closed-end and open-end categories. CBA is not anxious to throw the whole of TILA open for statutory overhaul, but some surgical fixes might be helpful.

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We appreciate the opportunity to comment on this ANPR, and look forward to working with the Board and its staff as the matter progresses. We will be happy to respond to any questions you may have about these comments.

Sincerely,

Ralph J. Rohner
Special Counsel

Steven I. Zeisel
Vice President and Senior Counsel